Environmental Finance

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Natural Capital, impact and climate represent a growing sleeve for investor allocations, writes David Shelton

There has been growing interest in the concept of a new Natural Capital asset class, combining forestry, agriculture and conservation assets. Currently, Natural Capital is estimated to represent 4.5% of global GDP but just 0.2% of institutional assets under management globally.

The UNEP estimates that 50% of the world's GDP is dependent on nature and its value to society is in the order of $125 trillion or x1.25 of global GDP1. This suggests investment in Natural Capital needs to increase, but where should it sit within an institutional investor's portfolio?

To understand where Natural Capital fits in a portfolio, one should consider both the fundamentals of the risk return profile, as well as alignment of the assets with broader objectives.

The diversification benefits investors typically seek from investing in these assets include low volatility with low correlation to other asset classes, relatively predictable income streams and positive correlation with inflation.

There are two important additional benefits of investing in Natural Capital. The increasing revenue streams from various climate and environment related investment options, such as carbon credits, biodiversity credits, biofuels, or renewable energy leases.

Secondly, the impact benefits such as climate change mitigation, becoming nature positive, or creating impact outcomes such as supporting rural communities.

Historical versus current Natural Capital allocations

A typical institutional investor has historically allocated between 1% to 5% of their overall portfolio to forestry and/or agriculture. This is usually in the context of a larger 15-25% allocation to private real assets within a broader infrastructure or alternatives allocation.

More recently we have seen institutional investors allocate capital as part of a newly created and dedicated climate investments allocation, investing in forestry and agriculture for their positive impact on mitigating climate change, in addition to the other attributes around correlations, volatility and attractive returns.

Some investors have established dedicated impact or climate portfolios, looking at concrete ways to incorporate impact into their investment allocations. So far, this has more commonly been seen with clients in Europe, compared to other parts of the world.

Expanding Natural Capital allocation considerations

With the push towards Net Zero and decarbonisation, institutional, corporate and private investors, are exploring new investment models that create both conventional returns as well as carbon offsets, credits or quantified climate mitigation benefits. This has the added benefit of increasing the pool of potential investments available to investors.

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Corporates mostly seek investments creating carbon offsets at the lowest cost, while investors may seek to maximise carbon offset value to increase returns. In some cases, investors want to secure carbon offsets for portfolio decarbonisation goals, or simply want net carbon removals or reduced emissions in land use investments to balance the emissions associated with investments in infrastructure or real estate.

The emerging Natural Capital asset class offers a diversity of investment approaches depending on whether the objective is to maximise returns, secure low-cost carbon offsets, or create a structured portfolio decarbonisation process alongside risk return considerations.

Adding climate objectives to portfolio allocation policy

Changing portfolio allocation techniques to consider Natural Capital involves transitioning from optimising risk and return; to risk, return and climate outcomes for example. Creating a portfolio optimisation model to support decarbonisation or biodiversity goals adds a further dimension to the traditional framework, allowing investors to consider trade-offs between risk, return and a defined decarbonisation or biodiversity trajectory for investments.

From a portfolio management perspective, a consideration would be to select forestry assets with the objective of maximising carbon dioxide emissions removals per million

dollars of asset value[2]. For example, reforestation projects; investing in immature forests with high rates of carbon sequestration; or embedding conservation projects in forestry and agriculture investments.

Optimising results from carbon aware model

An investment manager with detailed understanding of the types of Natural Capital assets available to meet an investor's objectives, is essential. Rather than viewing a Natural Capital investment allocation as a homogenous asset class, allocations may have specific impact or biodiversity goals, that maximise and optimise land use decisions through time.

Designing a Natural Capital strategy where investment is focused on global regions with faster biological growth rates or areas and asset types that have been under invested, has the potential to sequester more carbon and reach decarbonisation goals sooner.

As clarity emerges around metrics for biodiversity assets, portfolios could also encompass broader nature positive objectives alongside net zero emissions objectives. This may lead to comprehensive natural capital accounting across carbon, biodiversity, freshwater regulation and other key impact objectives.

Investors must seek a manager that offers sufficient optionality across areas such as land value, harvest income, carbon and biodiversity credits and the rapidly emerging circular bioeconomy to provide investors with the risk, return and the impact benefits they seek.

The best managers will also be those that have a deep understanding of upstream input fundamentals, and downstream processing and market development, for both core commodities, and emerging products.

Conclusion

Natural Capital, impact and climate represent a growing sleeve for allocations as investors increasingly see biodiversity, not just decarbonisation, as a key sustainability metric to track.

New Forests expects an increasing number of institutions to have a dedicated Natural Capital allocation with its own risk, return and impact metrics, whether this is through a commingled fund, a separate account, or a blended finance vehicle.

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Footnotes:

1 UN Environment Programme; Institute and Faculty of Actuaries, Natural Capital – an actuarial perspective, 26 April 2021